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C O N F I D E N T I A L SECTION 01 OF 03 YEREVAN 000139

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SUBJECT: ARMENIA'S 2005 BUDGET: MORE BUTTER, STILL PLENTY OF GUNS

REF: A) 04 YEREVAN 2510 B) 04 YEREVAN 2579 C) YEREVAN

52 D) YEREVAN 83

Classified By: DCM A.F. Godfrey for reasons 1.4 (b/d).

SUMMARY

1. (C) The GOAM has billed the 2005 budget as having a social focus. Both tax receipts and social spending are set to rise ambitiously in line with the GOAM's Poverty Reduction Strategy. After much debate, official defense spending is set to rise too, although spending on education will exceed official defense expenditures for the first time. The international donor community, especially the IMF, is skeptical, noting that the GOAM has moved significant revenues (and thus, presumably, expenditures) off-budget. Substantial non-tax revenues from the well-known Kajaran mine privatization are conspicuously absent from the budget. We believe that the budget does not represent the full extent of official expenditures. The government of Armenia appears to be moving important revenues off-budget, presumably in order to finance defense expenditures in Nagorno-Karabakh (ref B). End Summary.

BUDGET IN NUMBERS

2. (U) The Armenian state budget is small, even compared to Armenia's small GDP (forecast to be 2,058 billion dram or USD 4.12 billion in 2005). The 2005 budget predicts state revenues of 345 billion dram (USD 690.7 million) and state expenditures of 394 billion dram (USD 789.2 million), 16.7 and 19 percent of GDP, respectively. The GOAM relies on concessionary loans from International Financial Institutions (IFIs) to finance 34 billion drams (USD 69.3 million) of the budget deficit. The government will issue bonds -- sold domestically -- to meet the remaining deficit of 14.6 billion dram (USD 29.2 million). The lion's share of Armenia's outstanding debt is to International Financial Institutions, who agree that Armenia's debt is prudent and serviceable. The 2005 budget relies on a reasonable assumption of 8 percent growth in nominal GDP during 2005. (Note: All amounts are noticeably greater this year than last in dollar terms, as the Dram appreciated 16 percent on the dollar in 2004. End Note.)

SOCIAL SPENDING IN LINE WITH POVERTY REDUCTION STRATEGY

3. (U) During parliamentary budget debates, MP's and Ministry of Finance officials repeatedly stressed the social focus of the 2005 budget. The government is changing the budget in line with the guidelines set out last year by the Poverty Reduction Strategy Paper, reducing expenditures on subsidies and domestic interest payments, and increasing expenditures on health, education, social security. Spending on public health, education and social sector accounts for 35.6 percent of budget expenditures. The 2005 budget allocates 61.6 billion drams (USD 123.3 million) to education and science, up from 54.4 billion drams (USD 108.8 million) in 2004. Social security spending will be 46.5 billion drams (USD 93.1 million), 5 percent higher than in 2004, to meet programmed pension increases. The average social pension will increase by 1000 drams (USD 2) to 4000 drams (USD 8). These increases are broadly in line with the Poverty Reduction Strategy, which calls for increasing spending on health, education and social security by 1 percent of GDP in 2005. Paying for these increases depends on meeting the programmed increases in tax revenues, or cutting back other expenditures (which is how the government financed increased social payments last year).

MISSING REVENUES - PART ONE

14. (SBU) The GOAM's inability to adequately collect revenues continues to thwart full implementation of the Poverty Reduction Strategy. President Kocharian has declared 2005 the year of tax and customs reform. The President and his Chief Economic Advisor have publicly called for improvement of the tax administration both to increase revenue collection and to create a better tax environment for businesses (refs C and D). The 2005 budget reflects this, calling for an increase in tax receipts of nearly 20 percent to 292 billion dram (USD 585 million). This would bring tax revenues to 14.1 percent of projected GDP, still shy of the 18.8 percent goal set out in the GOAM's Poverty Reduction Strategy Paper.

15. (SBU) The programmed increase in tax collections seems optimistic when compared to past outcomes. Last year's budget called for a 16 percent increase (on top of growth) in tax collection, but in fact tax revenue fell as a percentage of GDP in 2004. According to the budget, the programmed higher tax revenues are based solely on "expected improvements in (tax) administration" and the introduction of the minimum tax to catch businesses who evade taxation. Comment: If the government is successful in genuinely reforming the tax administration, there is enough slack in the current tax system to increase revenues considerably. But such reform would require political will that has proven elusive in the past (ref C). End Comment.

MISSING REVENUES - PART TWO

16. (C) Another cause of Armenia's anemic on-budget cash flow is that the GOAM moves some revenue streams off the official budget (refs A and B). (Comment: While Armenia claims it does not provide for the defense of the ostensibly independant Nagorno-Karabakh, in fact it is common knowledge that it does. Keeping expenditures for the defense of Nagorno-Karabakh out of public documents is almost certainly the primary reason the GOAM keeps revenues and expenses off the official budget. End Comment.) In a December 7, 2004 meeting with the Ambassador, the IMF Resident Representative James McHugh said that he suspected that the Government of Armenia has been increasing the amount of expenditures and revenues that it kept off-budget in 2004.

17. (C) The recent sale of the Kajaran Copper Molybdenum plant for USD 132 million (18 percent of officially projected 2005 tax revenues) was conspicuously absent from the government's non-tax revenue report. (The 2004 operational profits from the Kajaran mine, more than USD 20 million, were also diverted off-budget to a Fund under the control of the Ministry of Defense (ref A).) From a final sale price of USD 132 million, only 17.5 billion dram (USD 35 million) appears in the state budget. According to a December 2004 government signed by the Government's Chief of Staff, the rest of the money is to be directed to various off-budget state-controlled funds. Some of this redirection is for the type of spending that is traditionally on-budget in other countries. For example, the City of Kajaran (where the mine is located) is to receive 32.1 million dollars. An appendix to the decree cites a decision by the City of Kajaran to then give USD 5 million to the Ministry of Defense and another USD 27 million to Armgasard, a defunct state-owned energy company whose debts are administered by the Ministry of Energy. The municipality will in fact keep only USD 100,000 to refurbish a kindergarten and a municipal building.

ON-BUDGET DEFENSE EXPENDITURES ARE UP

18. (C) After an initial official press announcement that defense spending would not rise, and then a heated cabinet debate, the official defense allocation is up 22.4 percent from the 2004 budget to 61 billion drams (USD 122 million). Official defense expenditures account for 3.6 percent of estimated GDP, the second highest ratio in the former Soviet Union. The President's economic advisor, Vahram Nercissiantz, told us that the Minister of Finance wanted to keep the increase in defense spending entirely off-budget because he (incorrectly) thought that an IMF rule prohibited defense spending above a certain level. Nercissiantz said that, in a heated cabinet debate, he and others urged the Minister to move a large portion of the increase on budget, in part to improve transparency and in part to make a show of the increased defense spending.

COMMENT: STILL A DEFENSE BUDGET

19. (C) The characterization of Armenia's 2005 budget as a social budget is slightly disingenuous. The government has programmed significant increases in social spending, but the official budget represents only part of government spending. While increasing tax revenues still remains an important part

of the government's poverty reduction strategy, a large part of the missing revenues are intentionally moved off budget. (Armenia has the lowest revenue-to-GDP ratio in the CIS.) There is no public debate in Armenia about the propriety of financing the defense of Nagorno-Karabakh. Published government decrees show that the Ministry of Defense receives more money than is accounted for by its line in the budget, and that important revenue streams are diverted to funds controlled by the Ministry of Defense with no accountability to the National Assembly or Ministry of Finance auditors. Were these expenditures to be counted, the 2005 "social" budget would look more like the defense budget that it does.

EVANS